6.04 Lower of Cost or Market or Lower of Cost or NRV Rule

Overview

Conservatism & Matching

Regardless of the choice of inventory costing method, a company must account for declines in the market value of unsold inventories. (ASC 330) To do this, we have two methods:

- **Lower of Cost or Market (LCM)** – This somewhat complicated approach applies only to inventory accounted for under the *LIFO or retail inventory methods*.
- **Lower of Cost or Net Realizable Value (LCNRV)** – This simplified approach applies to all other inventory.

Regardless of the costing or valuation method used, if the prices of goods in inventory have been consistently:

- *Rising*, then the valuation will usually be at *cost*.
- *Falling*, then the valuation will usually be at *market value*.

Inventory *valuation* may be based upon:

- Individual items
- Categories
- Total inventory

Losses are recognized immediately on the income statement. Once inventory is written down, there is **no recovery** from the write down until the units are sold.

Loss on inventory (market decline)	X	
Inventory		X

Lower of Cost or Market (LCM)

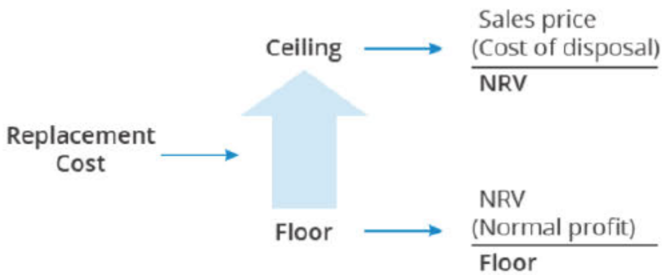
There are three different numbers that need to be computed to determine "market" under LCM:

- **Net realizable value (NRV)** – the estimated selling price of the goods less costs of disposal (eg, necessary costs to complete the goods, freight-out, and sales commissions)—**Ceiling**
- **Replacement cost** – the estimated cost to purchase or reproduce the goods
- **NRV less normal profit margin** – the price at which no profit would be made—**Floor**

Normally, replacement cost is used as market because it is generally lower than the NRV (ie, the ceiling) and higher than the NRV less normal profit margin (ie, the floor). However, when replacement cost is:

- Higher than NRV, the NRV (ie, the ceiling) is used as market.
- Lower than the NRV less normal profit margin (ie, the floor), NRV less normal profit margin is used as market.

Thus, the amount to be used as market will always be the amount in the middle. If market is lower than the original cost, the inventory must be written down.



Assume the following facts:

Replacement cost	100
Estimated selling price	120
Estimated selling expenses	30
Normal profit margin	20

From the above information, we can determine the normal, ceiling, and floor amounts for market:

Normal: Replacement cost	100
Ceiling: Net realizable value	90
Floor: NRV – normal profit margin	70

Since the replacement cost of 100 exceeds the ceiling of 90, market is 90, and that number will be compared with historical cost to determine the lower of cost or market.

Lower of Cost or NRV (LCNRV)

Under LCNRV, the amount to be used as the market value will always be NRV. If the NRV is lower than the original cost, the inventory must be written down.

Summary	
LIFO & retail Inventory methods	**All other inventory costing methods**
LCM – Lower of: • Cost = original cost • Market = middle of three numbers: o Net Realizable Value (NRV)—Ceiling o Replacement cost o NRV less normal profit margin—Floor	**LCNRV** – Lower of: • Cost = original cost • NRV = Sales price – cost of disposal